S. HRG. 101-271, PT. 1

ROUNDTABLE DISCUSSIONS WITH U.S. WINNERS OF THE NOBEL PRIZE IN ECONOMICS: LAWRENCE R. KLEIN

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

PART 1

APRIL 12, 1989

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

21-875 WASHINGTON : 1989

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

J841-24

JOINT ECONOMIC COMMITTEE

[Created pursuant to sec. 5(a) of Public Law 304, 79th Cong.]

HOUSE OF REPRESENTATIVES

LEE H. HAMILTON, Indiana,
Chairman
AUGUSTUS F. HAWKINS, California
DAVID R. OBEY, Wisconsin
JAMES H. SCHEUER, New York
FORTNEY PETE STARK, California
STEPHEN J. SOLARZ, New York
CHALMERS P. WYLIE, Ohio
OLYMPIA J. SNOWE, Maine
HAMILTON FISH, JR., New York
FREDERICK S. UPTON, Michigan

SENATE

PAUL S. SARBANES, Maryland,
Vice Chairman
LLOYD BENTSEN, Texas
EDWARD M. KENNEDY, Massachusetts
JEFF BINGAMAN, New Mexico
ALBERT GORE, JR., Tennessee
RICHARD H. BRYAN, Nevada
WILLIAM V. ROTH, JR., Delaware
STEVE SYMMS, Idaho
PETE WILSON, California
CONNIE MACK, Florida

JOSEPH J. MINARIK, *Executive Director*
RICHARD F KAUFMAN, *General Counsel*
STEPHEN QUICK, *Chief Economist*
DAVID R. MALPASS, *Minority Staff Director*

CONTENTS

WITNESS AND STATEMENTS

WEDNESDAY, APRIL 12, 1989

Hamilton, Hon. Lee H., chairman of the Joint Economic Committee: Opening statement 1
Klein, Lawrence R., Benjamin Franklin Professor of Economics and Finance, University of Pennsylvania 2

ROUNDTABLE DISCUSSIONS WITH U.S. WINNERS OF THE NOBLE PRIZE IN ECONOMICS: LAWRENCE R. KLEIN

WEDNESDAY, APRIL 12, 1989

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 10:15 a.m., in room 2203, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton, Scheuer, and Solarz.

Also present: William Buechner, professional staff member.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The Joint Economic Committee will come to order.

This morning the Joint Economic Committee is very pleased to welcome Lawrence R. Klein, Benjamin Franklin Professor of Economics and Finance at the University of Pennsylvania and the 1980 winner of the Nobel Prize in Economics.

This is the first in a series of hearings the Joint Economic Committee plans to conduct during this Congress with the U.S. winners of the Nobel Prize. We are very fortunate that 14 of the 23 living winners of the Nobel Prize in Economics live or teach in the United States.

They are an invaluable pool of knowledge about our economy that the Congress has not done a very good job of tapping, and I hope these hearings can be a way of bringing their knowledge to bear on the major economic policy issues facing the Congress during the next 2 years.

Professor Klein won the Nobel Prize in Economics in 1980 for his work in macroeconometrics and, in particular, for his pioneering work on the kinds of large-scale economic models that are used by the Office of Management and Budget, the Congressional Budget Office, and businesses throughout the country for forecasting the performance of the economy.

With the economic outlook so uncertain and analysts concerned about whether the U.S. economy is facing a recession or another bout of inflation, we are fortunate to have Mr. Klein with us this morning.

Mr. Klein was not asked to prepare a formal opening statement, but in my letter to him I asked Mr. Klein if he would begin this

morning's discussion with his thoughts on the major problems facing the American economy and his policy suggestions.

Mr. Klein, we welcome you before the committee and we'll turn to you for any comments you choose to make. Then we'll open it up for discussion.

STATEMENT OF LAWRENCE R. KLEIN, BENJAMIN FRANKLIN PROFESSOR OF ECONOMICS AND FINANCE, UNIVERSITY OF PENNSYLVANIA

Mr. KLEIN. Thank you, Mr. Chairman, for giving me this opportunity to discuss interesting economic issues with you and your committee members.

Overall, one would say that we are in an era of great prosperity. Indeed, I think all during the election campaign that was the picture that was painted for this country, and as far as our partner countries in the Western Alliance are concerned, one would say the same thing, that this is a period of very good times.

Yet, there are very serious problems underneath the surface and, also, the good times don't apply to everyone. Those are the kinds of issues that are to be discussed this morning.

I've made a list of several relevant economic questions that have not been resolved, that loom very large before us. The first of these is obviously the twin deficits, the Federal budget deficit and the foreign trade deficit.

I want to say just a few words about this because there are two points of view in the economic profession that might suggest that we shouldn't worry so much about these. One point of view is that the world has possibly changed and the country now can live with very large deficits, where we formerly did not think so or maybe formerly could not do so.

But at the present time people are raising the question whether the world has changed.

The second issue is that Robert Eisner, former president of the American Economic Association, has written extensively on the matter that we don't measure the deficit properly, and the deficit is not so bad if we make the proper measurement.

Now, I would like to respond to these two points of view by saying that the twin deficits are problems. The world has not changed, though we may find protracted periods of even a few years or many months in which the serious problems don't surface. Also, that the measurement problem is not the relevant issue. We have always had the measurement problems of treating the valuation of government assets, and also the State and local surpluses and the Social Security funds are all complicating issues.

Nevertheless, the Government must market securities and cover what they would call a nominal deficit, no matter what sophisticated measurement is used for another version of the deficit, and the principal question is, At what interest rates will the market take up these bonds that the Government must market to cover the deficit?

I believe the interest rate that is being asked in order to clear the market of these borrowings is high. High in a historical perspective, high in the sense of what our goals for the economy ought

to be. One goal for the economy certainly should be to have a higher savings, higher investment economy.

The high-interest rates might help savings, but really not very much. But they certainly do, in my opinion, retard investment.

The other deficit, the foreign trade deficit, I believe, is also quite relevant because in our current account we must have the interest payments on the foreign holdings of our debt, and that is making it very difficult for us to offset a very serious goods or merchandise deficit with invisible earnings.

We used to cover our merchandise deficit with the surplus on the invisible account. Now that's more and more difficult, or even impossible at the present time.

The interest rate works against us in that respect, and unless we do something first about the Federal budget deficit, which is something we can do something about, we won't really get to the problems of the foreign trade deficit because we won't get the investment in competitiveness and economic efficiency that we need. And in that case, it will become more and more difficult to find buyers for the American public debt throughout the world.

These two problems are very closely intertwined and they should not be separated. But our primary action must come on the Federal budget deficit. We cannot tell foreign countries what to buy and sell, and that is the main determinant of our foreign trade deficit.

One other respect in which the Federal budget deficit is a very serious issue is that in the end the Federal Government has the power over the printing press, and there is always a temptation to finance the deficit in an easier way. I'm not saying that present authorities are moving in that direction, but that always hangs in the balance. For that reason, it is not entirely appropriate to make a consolidated deficit calculation in which we lump the State and local surpluses and offset in part the Federal deficit.

The Federal deficit is a key deficit by itself, and for that reason, is a serious problem. And it's a serious problem for the monetary authorities of the Federal Government.

Now, I think we all know and appreciate the twin deficits problem. And in my opinion, the only appropriate way to approach that problem is in a balanced way. It should not be all taxation. It should not be all spending. It should not all be one kind of spending.

But the economy functions much better when policies are balanced, and a balanced policy would mean that some increase in revenues through higher taxation, some decrease in spending and some decrease in spending across a wide variety of categories and in a balanced program we should certainly bring down the Federal budget deficit.

Then I think other things would follow that would be helpful with regard to the foreign trade deficit.

I want to mention the second problem. That is an energy problem.

I think it is very unfortunate that this country has no very clear energy policy. We were on an excellent path toward conservation and efficiency in energy use. Indeed, almost every year since 1973 the number of Btu's per unit of the GNP has fallen. And this has been a very impressive program.

I think dropping the speed limits, dropping of miles per gallon requirements for the automobile fleet are lowering efficiency. Turning away from tax incentives for fuel efficiency, particularly in insulation or experiments with synthetic fuels and increasing natural gas production, improving coal technologies also hurt efficiency.

All of these should be followed to get us back on the path of conservation.

Once the world oil price fell drastically in 1986, the American economy as a whole immediately started importing more oil and we're at a rate of between 1 and 2 million barrels a day above what the former level was when we were conserving very well.

This shows up, in addition, in our foreign trade balance as an item that could be significantly cut if we were to go back to stricter use of energy and keep the country on a route of energy conservation plus production of substitute fuels.

Another problem is not entirely an American problem, but certainly one that involves our economy. That is the debt problem for developing countries. We are involved, of course, because many of the creditors are American financial institutions. But we are involved because we must have better relations with the Third World.

When we say that the world economy looks prosperous, in the same sense that the American economy looks prosperous, we are glossing over the fact that there are parts of the world that are in severe chronic or critical economic recessionary conditions.

Africa, particularly sub-Saharan Africa, is chronically in a bad state.

Latin America is probably temporarily in a bad state, but one that is very explosive and has a great deal of political ramifications.

And the oil-importing countries in the Middle East are in bad condition.

So, the great prosperity for the world is very unevenly distributed.

I think the debt problem is a very serious impediment to the turning around of our foreign trade position, getting the deficit reduced or turning the deficit into balance. In 1982, once the debt problem surfaced in its most obvious form, our exports to the Third World started to fall.

We used to send about 40 percent of American exports to the Third World. Now that figure is at least between 5 and 10 points lower, and we probably will not make a very satisfactory long-term improvement in our trade balance until we get back to a position of better exports to the Third World. And as long as the debt problem remains a serious obstacle, Third World countries will have to cut back on imports from the United States and other Western-exporting countries.

The problem of inflation is very much in the news today. I believe that the rate of inflation will probably go up. It has gone up in 1988. It will probably go up in 1989. However, I don't regard the inflation problem as one of extreme concern at this time.

We should always be vigilant. We should always be watching the inflation problem. But it doesn't seem to me that the American

economy is on a takeoff position into hyper or strong inflation, or accelerated inflation.

I believe that basically the inflation rate is under control, although it may be one or two points higher than it was at the best position in, say, 1986–87.

As for the problems of the economy as a whole, I emphasize what I would call macroeconomic problems in this brief outline. But, I think even though we might feel very uncomfortable with the present state of the macroeconomy, not necessarily its future state, that we foresee, but by its present state.

I think that there are very serious problems of deterioration on the matters of distribution. By distribution I mean income distribution, wealth distribution, housing distribution, whatever.

For some time the income distribution in the United States has been getting more unequal. This is a process that probably started 20 years ago, but it accelerated in the 1980's. And we have serious spinoffs from that problem. The homeless problem is obvious to anyone who lives in northeastern cities in the United States. And I believe that we should be paying more attention in our economic policy to the problems of distribution.

We shouldn't look at every piece of legislation or every piece of policy and ask what it will do to the macroeconomy. I think that is the way the minimum wage legislation is being looked at. What will it do to the inflation rate?

I think we have to go back to consider what has happened in terms of income distribution and in terms of poverty and in terms of homelessness and reconsider what our priorities are and what our objectives are and see if policy can be directed, to some extent, to the problem of distribution, as well as to the overall performance of the economy.

There are many more problems. I am not going to give a lecture on all of the issues. But these are the main policy areas and economic problem areas that seem to strike me at this moment.

Representative HAMILTON. Thank you very much, Mr. Klein.

I want to encourage my colleagues here just to join in whenever you want to. We're not going to follow a very strict procedure here.

There is an article in the Washington Post this morning by one of our economic writers who says that what this country needs is a good recession. Did you see that article?

Mr. KLEIN. I didn't see that.

Representative HAMILTON. It's Mr. Samuelson's article.

His point is that we need a modest recession in order to get the inflation rate down. You don't seem to be much worried about the inflation problem at the present time and you would not favor putting the country into a modest recession at this point?

Mr. KLEIN. I think it's very difficult to ask for a recession at any time unless one knew that too much steam had been put into the economy. However, I do believe that there is an inviolable law of economics. Even you powerful people in Washington can't repeal those laws, and that is that we live in a business cycle environment.

We have had cycles for more than 100 years, maybe 150 years, and one would normally expect a recession at this time. It was probably delayed from 1986 by the drop in oil prices.

But there are very few times when we have missed the chronology.

Representative HAMILTON. Let me follow up here, and then turn to Congressman Scheuer, on the points you were making.

Does it take policy mistakes to put us into a recession or will a recession occur anyway, whether or not there are policy mistakes?

Mr. KLEIN. Policy mistakes could cause a recession, but I don't regard that as really the principal cause of recessions. Recessions do have their own internal mechanism. Overbuilding, overexpansion and then cutbacks.

The policymakers right now have a very fine line to tread. One reason is that we have a very unbalanced policy. That was why I asked for balance in the fiscal policy.

Representative HAMILTON. Are you worried about a recession then?

Mr. KLEIN. I'm expecting a recession to occur in the normal course of events, and I would expect a normal recession. A normal recession would be one in which we might slide in production by anywhere from 1 to 5 percent.

Representative HAMILTON. Do you think one will come in 1989?

Mr. KLEIN. I'm not going to say with 100 percent probability that that will happen. But there is a strong possibility that we will have a recession beginning in 1989.

Representative HAMILTON. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

We thoroughly enjoyed your remarks, Mr. Klein. I really enjoy this kind of a format, an informal get-together of this kind.

I have two questions. The first is to ask you if you would put a little meat on the skeleton of a possible doable program for debt reduction, both in the field of reduction of expenditures and in the field of revenue enhancement, tax increases or whatever.

I'd just like to footnote that a little bit in the field of program reductions. I'm sure you've read George Kennan's thoughts that he expressed before the Senate Foreign Relations Committee last week, where he bemoaned the fact that we hadn't responded to Gorbachev's many suggestions that we could wind down this whole military situation expeditiously.

Of course, if we did respond, there would be enormous savings on both sides of the East-West conflict and that would have incalculable implications for our economy, as maybe would other kinds of initiatives on military reductions that are too important to be left to the generals, or at least solely to the generals.

So, can you put yourself in George Kennan's shoes and suggest the kinds of initiatives we can take in response to the whole sea change in the international picture in the last 18 months, at least in the sense that we could defer, stretch out, or put in a holding pattern major weapons systems and major military programs to be able to test and probe and see whether the Russians were willing to put their money where their mouth is.

And I must say, as a footnote to Gorbachev's initiatives, we've had the CIA testify here and they have always said that, despite all the rhetoric, there isn't any clear signal, there aren't any clear indexes that the Russians are reducing the volume of military expenditures.

There seems to be evidence that they are changing from an offensive to a defense posture, but not much reduction of military expenditures.

Anyway, what opportunities does that whole sea change in the international environment open up for reduction of expenditures?

Now, to get to revenue enhancement. You mentioned energy. Time magazine a month ago, 6 weeks ago, in its issue on "Globe of the Year"—they substituted "Globe of the Year" for "Man of the Year"—recommended a 50-cent tax on gas. As you know, a penny a gallon equals a billion dollars.

So, we'd have a $50 billion windfall right there. Plus there would be tremendous incentives to go back to all of the gasoline savings that you outlined that would be so useful, especially the incentives when you get above the $1 a gallon level, or maybe even approaching it, for automobile manufacturers to put in some of the fuel savings devices, the fuel economy devices, that other countries are producing, we understand.

The Japanese, the West Germans, the Swedes, and the French all have prototype car models on the table that would give them roughly 80 to 100 miles per gallon.

But with gas so cheap here, it doesn't pay the manufacturers to get into that because it doesn't pay consumers to spend an extra $1,000, for instance, on the car because with gas at $1 a gallon it would take them 3 or 4 years to get their investment back.

But if the gas price got anywhere close to what the Europeans pay, or in fact any of the Western industrialized nations, which is $2.50 to $3 a gallon, then it would be worth it for them to think about paying a bit more for a car that was very fuel efficient.

This is my first question.

My second question is on the question of international debt adjustment. Do you see any possibility of making realistic progress in the area of debt for nature swaps? You're familiar with that shorthand. I don't have to elaborate.

How can we put together a package that would be acceptable to these Third World countries that would both increase their ability to place new debt and be an acceptable deal for them on agreeing to better environmental behavior than they have in the past?

I apologize for throwing all that at you at one time.

Mr. KLEIN. Let me respond to the first set of comments or questions dealing with a program for debt reduction or actually for deficit reduction.

We may not entirely eliminate the deficit. We may reduce it a lot, but that would mean the debt would still continue to grow if there were any deficit.

But I do agree with you that the world has never been in a better position for mutual disengagement or disarmament than it is at the present time, certainly among the big powers, and I think we should follow through on that initiative.

Now, I have been making a lot of academic-type calculations on the contribution of the Soviet cutback to the civilian performance of the Soviet economy, and I believe that ground forces—conventional forces—are probably a bigger contributor than anything else. And it would be in the interests of the Soviet Union to try to get some more civilian growth. They sorely need it.

But, the program would have to be at least two or three times as big as the program that Gorbachev has already announced in order to get significant feedback, in fact, on civilian growth.

Those are the rough outlines of the calculations that I've been making on this. I would say that it is a possibility if we did respond, and so this is an opportunity for mutual discussion.

I'm sure, in addition, that weapons systems and other material problems could come in for discussion for cutback. But I see the main source as coming from the ground forces.

Now, I believe that the Soviet economy, as I said, really needs this for their own civilian output. They are probably growing at no more than about 2 percent a year now, which is very slow, in terms of their aspirations.

Such savings could be fed back into the American economy, as well. But I also believe that a world pool of the order of magnitude of $50 billion a year could be realized by simultaneous defense cutback of all the NATO and Warsaw Pact countries. And this world pool could go toward realizing the plight of the countries that are burdened by the very heavy debt commitments.

But, within our own country, certainly military spending is one area—one targeted area—for budgetary slow down, not a reduction, but a slowing down of the growth rate that is implicit.

Another area is in some of the entitlements. I'm not going to try to be specific this morning. But there are various entitlement programs that can be scaled back.

However, in an effort to do something about the distribution question that I raised, there will have to be some other areas that have higher priority and get more spending.

Representative HAMILTON. Do you believe we are favoring the old people against the young people?

Mr. KLEIN. Well, I didn't retire at age 65, and I think retirement at age 65 is not in accordance with medical advancement, health advancement.

Representative SCHEUER. And life expectancy.

Mr. KLEIN. And life expectancy.

And I think if we would stretch out the retirement age by 6 months, a month at a time, for 6 months, there could be very significant savings. There is no reason not to do that.

I think we should recognize over several decades that there have been these significant health and medical advances, and we recognize that by stretching out a little bit the age of retirement. There are other parts of the entitlement program that are vulnerable for trimming back.

On the question of revenues, I believe a tax on gasoline is one way to go. An oil import duty is another one.

Many economists object to the oil import duty as being protectionist. But I would remind everyone that Adam Smith always had his exceptions for free trade, and I think if we go back to review the history of what happened in this country from 1970 until now with regard to energy prices and treatment by the world energy producers vis-a-vis our country, we would be justified in making another exception to free trade and putting on an oil import duty.

But, wherever the revenue came from, a tax at the pump or an oil import fee, I think is not especially important. But we should do

it. And in addition, of course, we should support the oil tax by going back to the speed limit setting of 55 miles and going back to high requirements for the automobile manufacturers in miles per gallon.

That would be a very good source of revenue.

I also feel that it's a mark of a rich, wealthy, well-meaning country to have more progressivity in the tax system. I don't agree with the principles of the 1987 tax reform to take away progressivity or reduce the degree of progressivity.

It's a tradition in this country, a longstanding tradition, that ability to pay is a very significant criteria, and I think we should reapproach the distributional problems. And I would put a little more progressivity into the income tax system.

Representative SCHEUER. How about the Willie Sutton phenomenon?

Mr. KLEIN. You go where the money is.

Representative SCHEUER. John Kenneth Galbraith, who is a good friend of mine, wrote a New York Times Magazine article a few years ago in which he supported a national sales tax, or some variety of that, and he explained it to me.

I said, gee whiz, you're a great liberal and so forth. How can you be supportive of a regressive tax like that? He gave me the Willie Sutton phenomenon.

Mr. KLEIN. You go where the money is. But a more fundamental change would be to move it to an expenditure base rather than an income base. That is, in my opinion, more massive in terms of the mechanics of tax reform than the reform package that we had.

I would not disagree with that and it could be calibrated to enhance revenues.

Representative SCHEUER. Would you be sympathetic at all to the concept of a small increase in the income tax or a 1 or 2 percent sales tax, or a small value-added tax?

Mr. KLEIN. Those are all possibilities.

I would prefer more income tax collections to any of the others in that package.

Representative SCHEUER. Thank you very much, Mr. Chairman.

Representative HAMILTON. Congressman Solarz.

Representative SOLARZ. Thank you, Mr. Chairman.

Mr. Klein, in terms of our ability to maintain a relatively prosperous country that can compete economically with the rest of the world, what would you say is the most serious long-term economic problem confronting the country?

Mr. KLEIN. I said the twin deficits were a problem because they are very closely tied to the objective of making this country more high saving, high investment, and I think the issue is capital formation. Not entirely that, but that's a very important aspect of it, to get more modern fixed capital, highly productive fixed capital, in place, and to shift over to thriftier, more technologically oriented economy.

That will improve economic efficiency, productivity, and help to make us competitive.

Representative SOLARZ. How much of an increase in investment do you think will be necessary or desirable in order to achieve that objective?

Mr. KLEIN. I don't really know a quick answer to that in the sense that it depends where we invest, what are the new breakthrough technologies.

However, I think that the American economy ought to have a personal savings rate above 10 percent. We traditionally thought of the American personal savings rate as about 10 percent, from long historical statistics. We should go back to at least 10 percent, and possibly above, and then have an investment rate that goes up by about the same amount.

Representative SOLARZ. It's now about 3 or 4 percent?

Mr. KLEIN. Yes, it varies quarter to quarter, month to month. But it's probably between 4 and 5 percent now. It has been as low as 3 percent.

Representative SOLARZ. What would we have to do to get it to 10 percent or above?

Mr. KLEIN. Well, you'd have to do two kinds of things. First, you would have to approach the problem from the side of savings, to induce higher savings, and, second, to induce higher investment.

From the side of saving, I believe, that the inducements, the IRA's and some of the other inducements, are worth reinstalling in full force. The IRA's are in a watered-down state at the moment. But to restore the IRA's as they were would be a move in the right direction.

An idea that I long toyed with is to make private pension schemes fully portable from company to company for the great bulk of beneficiaries or payers.

This is done in some plans. We have a great university plan. It enables us to move from university to university and carry our pension rights. But many workers can't do this.

Representative SOLARZ. What would you think as a way of increasing the savings rate of requiring an increase in the minimum down payment which people have to make for a car or for the purchase of a home?

Mr. KLEIN. We used that technique after the Second World War to control spending, and European countries used it a great deal. It's not a bad technique. There are two ways of approaching savings.

You're trying to cut spending, or to try to make people to want to save. This operates from the side of holding down spending. And I would rather make saving more attractive. Now, something fundamental, an expenditure tax, would be one way for the inducements.

Representative HAMILTON. Does the savings rate in the United States follow incentives? Since I've been in the Congress we've voted all kinds of incentives for savings and I don't know that there is any very direct relationship between what we do with respect to incentives we put in the Tax Code and the result.

Mr. KLEIN. Over the years we've noticed that homeowners tended to be bigger savers than nonhomeowners, other things being equal.

People on good pension schemes tend to be bigger savers than people not on good pension schemes, other things being constant.

Representative SOLARZ. If you'll just forgive me on that point, that seems counterintuitive. I would think that if you have a good

pension plan you're more secure about your old age. You have less need to put away money for an emergency.

Whereas, if you don't have a good pension plan, people have incentives to salt it away.

Mr. KLEIN. A good pension plan has two features.

First, you don't get it for free. You pay for it. And if it's a good plan, you're willing to put more into it, particularly if it has a portability characteristic. Then it's more attractive.

Second, there are discretionary amounts of money plans. People can go above fixed minimum, and there would be an attraction to people to put more in on a discretionary basis.

Representative SOLARZ. The pension plan itself, of course, is a form of savings.

Mr. KLEIN. Exactly.

Representative SOLARZ. Mr. Klein, could you tell us why the trade deficit has not declined more than it has, given the rather significant drop in the value in the dollar which led many people, I gather, including yourself, to provide some rather sanguine projections about what would happen to the trade deficit?

Mr. KLEIN. I think the trade deficit is moving in the right direction, the direction we would expect with dollar depreciation, but not as fast as we had wanted and by not as much as we had wanted.

First, consider agriculture. We have traditionally had a very big agricultural export surplus. Politically we lost after the Soviet grain embargo in 1980, and we've had some trouble recouping that market. That's beginning to come back.

And in this period of time, other countries became major competitors in the grain market. Brazil, Argentina, Australia, other countries captured some of our market. We have to get it back, and they've been fighting to keep it.

Brazil has become a major soy bean producer now. Argentina is very big in some of the grain fields that we have been in, and they're quite willing to keep the Soviet-Chinese market, if they can.

A second issue has been the interest rate. That doesn't show up on the merchandise trade balance, but it does in the current account, and that has been holding down our current account making the deficit bigger than it otherwise would be.

There are more overseas companies earning in the American market than before. They have invested here and we're losing invisible payments in profits to them. And the passthrough, that is, the extent to which foreign sellers in the American market raised their American dollar prices as the dollar depreciated, has been pretty slow.

It isn't certain whether it's slower than in the past, but that has been a contributing factor. There's been a passthrough on the order of magnitude of probably 50 or 60 percent, and there has been an enormous drive on the part of foreign sellers in the American market to retain market share, and they have done it.

Representative HAMILTON. Is it likely that we'll have a trade deficit exceeding $100 billion for some time to come?

Mr. KLEIN. Are you talking about merchandise or the whole current account?

The merchandise deficit will stay large for quite a long while, until we become more efficient. The total deficit could become smaller on current account, if we get interest rates down.

Representative HAMILTON. When you talk about the twin deficits in your opening remarks you're talking about the current account?

Mr. KLEIN. Well, yes, I'm talking about the current account. That's probably the most important one to look at. But many people are concerned about the merchandise deficit as well. That's the trade account deficit.

I think we should probably focus on the current account.

Representative SOLARZ. Mr. Chairman, if I could ask one other question.

Mr. Klein, we now have the lowest unemployment rate that we've had in quite some time. It's 5 percent. What would you say is the full employment-unemployment figure? Do you think we can get it below where it is now? If so, how?

Mr. KLEIN. I think we can get it below. I think it could even go below 5 percent. You see, what economists call the full-employment rate of unemployment has been a declaration of despair. Whenever an administration could not reach a target, they raised the target level.

I think that was a swindle. When people talked about 6 percent unemployment as a full-employment rate, that was a pure swindle.

Representative HAMILTON. If you can't solve the problem, you redefine it?

Mr. KLEIN. That's the way many people suggested settling the war in Vietnam. Pull out and say we won.

But I think we had a very difficult period in the 1970's to absorb the baby-boom generation and to absorb the very high propensity of women to enter the labor force. Both of those have receded. The baby-boom generation has been absorbed, and women are still entering the labor force, but not at as high a rate.

So, our labor force growth is somewhat smaller, and it may even be smaller in the next 5 or 10 years. That in itself would have a tendency to bring down the unemployment rate. The other way we can do it is simply become more efficient.

We have high investment. In a more thrifty economy, that we can afford, we can get to lower levels of unemployment without having severe pressure.

Representative SOLARZ. How low do you think it can go without creating that severe inflation?

Mr. KLEIN. Traditionally, after the Second World War, we first thought of 3.5 percent. Then it drifted to 4 percent. Then came all the troubles. Absorbing the increased labor force, dealing with the disturbances of the 1970's.

Some people would have seen it as high as 6 percent. Those people, in my opinion, are people who say we could never get back to 5 percent without drastic inflationary pressure. And we could probably go below 5 percent. Somewhere between 4 and 5 percent is the rate.

We could probably, by becoming vastly more efficient, get back to 4 percent.

Representative SOLARZ. I wonder, finally, if you can reflect on a phenomenon that I find both puzzling and troublesome. That is, it

would appear that while the unemployment rate has gone down and the employment rate has gone up, the number of people in poverty has not substantially declined. In fact, it has actually been something of an increase.

Furthermore, we appear to have, throughout the country, pockets of hardcore unemployment that seem to be emerging into the phenomenon of the underclass. One out of every five children in the country lives in poverty.

I gather there are neighborhoods, particularly in some of the larger cities, where unemployment is very widespread. How do we deal with that phenomenon in the context of an economy that's moving forward, generating jobs, reducing unemployment?

You would think, all things being equal, that there would be a significant decrease in the poverty rate. That doesn't seem to be happening.

I'm very troubled by this. I think that this country somehow or other has an obligation, has to do better, has to find a different way to help those of our fellow Americans who have been left out, and who, by virtue of being left out, generally have stunted life's chances themselves and breed a host of pathologies which diminish the quality of life for everyone else.

It produces crime, drug addiction, and the like.

So, could you reflect on this phenomenon and perhaps share with us any thoughts you might have about how to deal with it?

Mr. KLEIN. Well, the comments you make I find to be very significant, and I'm sympathetic with your viewpoint on them. That is why in the opening remarks I said that we pay attention inordinately to the macromagnitudes, to GNP or per capita growth rate and some overall indicators for the economy. But we don't pay enough attention to the distributional problems.

The distributional problems are the ones that you are indeed mentioning. It is a reflection of the fact that you can have seeming prosperity and even very high living in the United States at the present time and also an increase in degree of poverty, or an increasingly unequal income distribution.

Well, how do we deal with that? That's a fact, that these distributional measures are deteriorating. How do you deal with them?

That's not a very easy problem, but certainly we need more job training. We need more youth job training. We need more on-the-job training.

I think the programs that we've had in the past didn't really make a big dent in that problem because I think they didn't train people for open-end jobs with a ladder of promotion and success. They tended to be mainly dead-end positions.

But I think we need to have a commitment to training and probably a cooperative scheme with the private sector for subsidized work at on-the-job training, in which people would have a chance of moving up the scale.

Second, the whole educational system needs support, and in these days when we're talking about budget cuts, we have to recognize that some things shouldn't be cut, and our priorities should be for expanding some things. In particular, I think elementary and high school education has deteriorated on the whole in this country and needs to be strengthened considerably.

And that's an area of budget priority which would contribute, not immediately, but within a school generation to improvement of the kinds of poverty tendencies that you see.

Representative SOLARZ. What is the basis on which you reach the judgment that elementary and secondary education is deteriorating?

Mr. KLEIN. First, of course, there are reports of scores. But I come across a wide variety of students I've taught in open systems, as a visitor in New York—and I've taught in Ivy League schools and I notice the training of the students that we get fresh from high schools. Somewhat by introspection you see how your own children, your relatives, are being taught in the school systems. And I also see a great deal of attention in school systems when I travel in other countries.

And you get the impression that American education excels at the highest level, at the university level, at the postgraduate level, and at the research level. But we are not doing as good a job at the elementary level. We get university students who have come from other backgrounds and they're much more rigorously trained in science and mathematics.

The National Science Foundation has elaborate sets of figures on comparison charts, comparisons of students in this country and other countries, and we just don't come out very well.

Representative HAMILTON. That's very interesting.

Mr. Klein, let me try to cover a few subjects with you quickly.

I'm interested in your views on industrial policy. Today we have the Defense Department running industrial policy in some respects with their interest in high-definition television and Sematech and these kinds of things. We seem to be kind of slipping into an industrial policy. We had some debate about it in the country a few years ago.

We basically came to the conclusion in that debate that we weren't going to have an industrial policy. Now we are having an industrial policy on an ad hoc basis.

What's your reaction to all that? Should the Government be subsidizing high-definition television?

Mr. KLEIN. Or encouraging it.

Representative HAMILTON. No, subsidizing it. We're putting a lot of money into it.

Mr. KLEIN. I support the concept of industrial policy. I know it went out of fashion. But, I was a supporter.

It is my firm opinion, having watched the Japan economy since 1960 at fairly close range, that they followed a very intensive industrial policy and it was very successful in achieving their objectives.

I think we should do some of the same, not necessarily using the same techniques. You can't always transplant techniques from one place to another.

Representative HAMILTON. But you don't draw back from the idea?

Did you favor the idea that the Government ought to identify certain industries to help directly?

Mr. KLEIN. Yes, but I don't think it should be in the hands of the Defense Department. It should be civilian oriented, and it should be well thought out.

I think we can target certain areas for technological improvement, for new breakthroughs, and we should encourage them and support them.

Representative HAMILTON. What about the idea of managed trade. How do you react to that? By that I mean things like quotas and voluntary restraint agreements, industrial policies and regulatory requirements and all the rest?

Mr. KLEIN. That part of industrial policy, I wouldn't recommend. That is, I think basically multilateral free trade is desirable.

I made one exception on the oil imports. Other than that, I would say that multilateral free trade is our national goal, and we've had that position for 40 or 50 years, and I think we should stick to it.

Representative HAMILTON. Is there evidence that countries that have managed trade do better than we do and have done? Do they have higher standards of living?

Mr. KLEIN. No, they don't have higher standards of living. I think if you made the right calculations, the American level of living is the highest per capita in the world, but some of the competitors are gaining on us. But I don't think their gains are due to managed trade.

I think if a country cultivates export markets, finds out what foreign tastes are, what foreign dimensions are, what foreign needs are and then targets on selling in that market, I don't regard that as managed trade. That's encouraging export trade. We've done too little of that.

But I think more than focusing on the trade side, the focus should be on productivity, technological advancement within the country and we should try to define the sectors of the economy we want to give support to for that.

But it should not be in the hands of the military.

Representative HAMILTON. What about the steel agreements that we have coming up for renewal here shortly. How do you feel about those? You know what I mean.

Mr. KLEIN. Voluntary import restrictions.

Representative HAMILTON. Yes, voluntary restraints.

Mr. KLEIN. I'm not in favor of those.

Representative HAMILTON. A lot of people from your State are.

Mr. KLEIN. Yes, that's self-interest.

I believe that we should push foreign steelmakers to be fairly competitive. But we should not put up the restraints.

Representative HAMILTON. You mentioned productivity.

Our productivity rate is not very impressive at the moment. What kinds of things would you do to get it up?

Mr. KLEIN. I believe that technical things, improving the research system, giving R&D tax credits, and just stimulating research in the higher educational system and research institutes for product development are the things to do.

There is one other point in general.

I think the American economy should restore the work ethic; that's a very difficult thing to reestablish. We've watched a country

that seemed to have a higher work ethic catch up to some extent to our position. I think we should devote some thought to generating a higher degree of work ethic in the sense of getting workers to be more concerned about product quality, about getting workers to be quite willing to put in a full day and not try to minimize the work.

Representative HAMILTON. What are you comments about present monetary policy in the Fed?

Mr. KLEIN. I think the problem with the Federal Reserve is that they are left to be the sole economic policymaker in the country.

Representative HAMILTON. We've defaulted on the fiscal side.

Mr. KLEIN. That's the whole point.

So everything is in the hands of the Federal Reserve. I think one could say that the Federal Reserve moves too far one way or another. But if they don't move, nobody moves. So it's putting the whole burden on them, and that's not their fault, but I think they are managing the burden reasonably well.

Representative HAMILTON. I wanted to ask you about economic models, just in a general way. We depend so heavily on economic forecasts in this business, in the Congress. Do we rely too much on these economic models, and how good are they? They vary a lot, I'm sure.

Mr. KLEIN. I guess it's my self-interest, but of course I'm in favor of modeling. I think the standards have become too weak, particularly within the Federal Government or within government in general.

The concept of a careful forecast is put aside and some number is put up. I think the quality standards have enormously deteriorated.

Representative HAMILTON. Can't we get some group of highly respected economists out there to make public statements from time to time about the validity of the economic assumptions under which we operate in budgeting?

Mr. KLEIN. Yes, I would approve of that. I am on the panel of the Congressional Budget Office.

We don't look over the forecasts in detail, but we look over the macroforecasts twice a year.

Representative HAMILTON. We operate today on a kind of best case assumption.

Mr. KLEIN. And that's wrong.

Representative HAMILTON. That's not prudent.

Mr. KLEIN. In the first place, the risks of being wrong should be factored into policymaking, and in the second place, we should look both at the high side and the low side, with an appropriate band in between.

By appropriate band I mean one that is scientifically established as closely as we can.

Representative HAMILTON. When you look at the budget projections you'll often see projections running out 5 years. Are those any good at all? I mean, for 5 years out, do they get progressively worse?

Mr. KLEIN. Yes. The forecast error grows with time. I think we have a rather good view 1 year ahead. One year ahead I think we are reasonably accurate.

Representative HAMILTON. One year?

Mr. KLEIN. One year.

Two years ahead we need to do in order to confirm the trends, whether we are going up or down. Five years has a very big error.

Representative HAMILTON. Is it a guess?

Mr. KLEIN. No, it's not a guess. But there are two comments that I would like to make about the 5-year forecasts.

In the first place, they should be rolling. That is, every month or every 6 months we should update the 5-year projections. Second, what we should do is to discount 5-year projections back to the present, that is if everything were divided by 1.1 to the fifth power, or something like that, we would then put the 5-year horizon in proper perspective in terms of today's uncertainty.

Representative HAMILTON. Let me ask you about the quality of government economic statistics.

The Chairman of the Council of Economic Advisers said the other day he was concerned about them. What's your observation about their quality? You deal with them all the time.

Mr. KLEIN. I deal with them all the time and I deal with these numbers around the world, from almost every major country.

I would say American statistics are very good on a world scale, but obviously there are areas where we have poor quality.

Representative HAMILTON. Are we slipping or getting better?

Mr. KLEIN. Well, I think budgetary cutbacks have worsened these statistics. We should be giving more priority in the budget to getting better statistics.

Representative HAMILTON. If you look back over your experience in dealing with these statistics, your general impression is that they have become better?

Mr. KLEIN. Oh, much better. I've been dealing with these statistics for almost 50 years and there isn't any question at all that they're enormously better than ever before.

Representative HAMILTON. But in the last few years you have a sense of some slippage?

Mr. KLEIN. Some slippage in the last few years.

Representative HAMILTON. OK. There are a lot of things I'd like to go over with you, but is it your sense that the American economy today, the performance of the American economy today, is much more dependent on the economic policies of other nations than it has ever been before, and how serious a problem is that for us?

Mr. KLEIN. I think it's a very serious problem. We are an open economy now.

The conventional textbook exposition of the American economy in freshman economics is as a closed system and that's entirely wrong and has been wrong for at least 10 or 15 years. And we are very heavily involved in the world economic situation and we are very heavily influenced by the economic decisionmaking in other countries, policy or otherwise, that is, private decisionmaking.

Representative HAMILTON. One of the economists who testified before us said something to the effect that he believes, for example, that Japan during the election year of 1988 had a major impact in manipulating the American economy through the exchange rates.

They wanted to see a certain result in the American election. They had considerable economic power to help bring that about.

Would you agree with that kind of an observation?

Mr. KLEIN. I would agree that intervention in the foreign exchange markets took place all during the summer of 1988 in the interest of stabilizing the dollar, not to make it high or low, but to keep it steady so that there would be no embarrassment to the administration.

Representative HAMILTON. Mr. Klein, we have a vote and by the time I'd get over there and vote and come back I think it would be time that you should leave in order to catch your train. So, I think we'd better just adjourn at this point.

Mr. KLEIN. Thank you.

Representative HAMILTON. I want to express my appreciation to you for this kind of wide-ranging discussion, which I find quite fascinating and helpful.

We appreciate your participation very much.

The committee stands adjourned.

[Whereupon, at 11:25 a.m., the committee adjourned, subject to the call of the Chair.]

○